K A N S A S

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DEPARTMENT OF CREDIT UNIONS

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TO: **Management of Kansas chartered credit unions**

SUBJECT: **Evaluation of Earnings**

Recently the National Credit Union Administration (NCUA) provided guidance to their field staff about evaluating earnings in federal credit unions (NCUA Letter to Federal Credit Unions No. 06-FCU-04 http://ncua.gov/letters/2006/FCU/06-FCU-04.pdf). The purpose of this bulletin is to provide guidance to Kansas chartered credit unions on earnings as we move through the current earnings environment. In recognition that maintaining adequate earnings is a complex aspect of credit union management, I encourage credit union officials to be diligent in the adoption of an approach balancing the net worth and earnings needs of their credit union with their long-term business objectives. I agree with much written in the NCUA's Letter and strongly encourage credit unions to review the Letter and the attached Supervisor Letter written to NCUA's field staff.

With risk-focused examinations, examiners are assigning risk levels to seven areas of risk. Additionally examiners refer to key ratios determined from the credit union's financial information for the capital, asset quality, and earnings components of the CAMEL. Key ratios are useful indicators of performance but assigning CAMEL ratings based on a matrix of key ratios alone is not the Department of Credit Union's practice. Key ratios and other information provide guidance for the examiner's final assessment of the individual component rating of the CAMEL. Examiners must look behind the financial information to determine the significance of the key ratios, trends, projections and interrelationships with the seven risk areas. Examiners have the discretion to increase or decrease any CAMEL rating if in their professional judgment a change in rating is justified.

Examiners evaluate each credit union's earnings level relative to net worth needs, financial and operational risk exposures, the current economic climate, and the institution's strategic plans. It is management's role to develop and follow a strategic plan that balances risk with earnings. Return on assets must be viewed by management and examiners in context of the success of the entire credit union operation. Management's capability in managing risk versus earnings must be considered. Lower return on asset levels may be viewed positively if they are the result of managements' sound and well-executed plan to balance risk or incur costs to position the credit union to achieve longer-term growth and member service objectives. Examiners recognize that the purpose for maintaining appropriate but not excessive retained earnings is for maintenance of net worth levels relative to the risk profile of the credit union. Returning excess capital to the membership or utilization of capital to achieve long-term objectives can contribute to the long-term success of credit unions.

Additionally, financial indicators such as key ratios are lagging indicators of risk. The key to successful risk management is effective overall credit union management since management impacts all seven-risk areas. CAMEL ratings are not to be viewed as a 'grade,' but as a tool to measure risk and one means for the Department of Credit Unions to allocate resources for supervision purposes.

Please contact this office or your examiner if you have questions or care to discuss the contents of this Bulletin.

John P. Smith, Administrator   August 22, 2006

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